NEED TO KNOW

AMERICANS FOR PROSPERITY FOUNDATION

STATE TAX CREDITS

State governments often provide "tax credits" in an attempt to encourage businesses and individuals to perform a specified activity. Tax credits reduce the amount that a business or individual owes the state government through a dollar for dollar reduction in tax liability. If a business owes $1,000 in taxes, and then receives a $250 tax credit, then the business only owes $750 total.

Tax credits can be redeemed against a variety of taxes, depending on the design of the program, including: income tax, property tax, sales taxes, and more. Nearly all states provide tax credit programs in some form.

Tax credits for businesses are used to encourage job creation, research and development, and investment. To a smaller degree, state governments also provide income subsidies to lower income individuals in the form of so-called "refundable tax credits." These credits are usually based on factors such as income and family status, and offset income, sales, and property taxes.

Although lower taxes seem like a good idea, tax credits only lower taxes for a select few and cause distortions in the tax code. By reducing the tax burden of a single targeted industry or company, the marginal tax rate for everybody else increases if overall government spending is not also reduced by the amount of the credit. At their core, tax credits are corporate welfare. All taxpayers bear the cost, but only special interests and politically connected industries benefit.

QUICK FACTS

- State Tax credits are growing in use. In Missouri, from 1998 to 2012 tax credit redemptions grew from $102.7 million to $615,896,450.42. That's an increase of just under 600 percent (1).

NOTABLE & QUOTABLE

"Neutrality: The fewer economic decisions that are made for tax reasons, the better. The primary purpose of taxes is to raise needed revenue, not to micromanage the economy. The tax system should not favor certain industries, activities, or products."

- **Tax Foundation**, The Principles of Sound Tax Policy (2)

THE EVIDENCE: TAX CREDIT PROGRAMS BREAK THEIR PROMISES

Targeted tax credit programs often fail to achieve the purposes that supporters cite in their favor: encouraging employment and helping states compete. The targeted tax credit programs are too narrow in focus and too limited in their eligibility requirements to be widely used to attract and retain jobs and capital investment.

Instead of creating economic activity, tax credits actually do the opposite and cause the overall state economy to shrink. They divert labor and capital away from other more productive activities that do not get subsidy. In fact, economists have found that there is a substitution in economic activity from all other industries to the ones receiving the tax credit (3).

There is no shortage of examples in the states. In Michigan, for example, the Mackinac Center for Public Policy found that only 7.9 percent of Michigan's tax credit projects were completed on time and produced the number of jobs promised (4). In Missouri, the state studied 19 businesses authorized for Enterprise Zone Tax Credits and Enhanced Enterprise Zone Tax Credits and found that and actual investment was 29.5 percent less than proposed (5).

In addition, these programs invite fraud. In practice, states that have both a multitude of exemptions, deductions, and credits but with few institutional checks on the size and scope of such programs have a higher potential for political abuse. In Iowa, for example, two film producers were caught inflating and falsifying expenses in order to obtain over $1.85 million in tax credits (6).

BAD FOR STATE BUDGETS

The refundable portion of tax credits are a form of direct government spending. In other words, a taxpayers fi¬nanced handout. Whenever the state government awards a refundable tax credit, it pays for that refundable tax credit by either a cut in other state programs, higher taxes, or taking on more debt (which eventually needs to get repaid through higher taxes).

Depending on the program, some credits do not have to be redeemed in the year that they were issued, meaning that the company can carry forward the benefit into future years. These unredeemed tax credits represent a future financial liability for the state government creating uncertainty and making forecasting and planning for future budgets difficult.

CONCLUSION

State governments should widen the tax base by eliminating targeted tax credits and cut overall tax rates instead of subsidizing politically connected industries and companies with tax credits. Consumers and investors—not politicians—should decide which industries, companies, and projects succeed by engaging in unrestricted trade. State tax dollars would be much better spent in the hands of individuals than on handouts for particular companies.

Endnotes:
1. http://tcrc.mo.gov/pdf/2012-tcrc-report.pdf
2. Tax Foundation, The Principles of Sound Tax Policy http://taxfoundation.org/article/principles-sound-tax-policy
3. Basker, Emek, “Labor-Market Effects of Wal-Mart Expansion,” Review of Economics and Statistics, vol. 87, no. 1, February 2005, pp. 174–183
4. LaFaive, Michael D., and Michael Hicks, Ph.D., “MEGA: A Retrospective Assessment,” Mackinac Center for Public Policy, April 2005. http://www.mackinac.org/7054
5. “Enterprise Zone and Enhanced Enterprise Zone Tax Credit Programs,” Office of the State Auditor of Missouri, Report No. 2010-106, Sept. 2010. http://www.auditor.mo.gov/press/2010-106.htm
6. Rood, Lee. “Criminal charges filed in Iowa film tax-credit scanal” Detroits Registrar, 8 February 2010. http://www.demoinsregister.com/article/20100208/NEWS10/100208018/1001/

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